European credit outlook 2021: a world of uncertainty

February 2021

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, this is not a guide to future performance.

Market summary

Covid-19-driven market disruption appears to have largely subsided

- Market prices reflect an optimistic recovery scenario alongside continuing monetary and fiscal support.
- Any hesitation, or suggestion, that quantitative easing (QE) will be tapered is likely to cause a sharp correction in credit markets, in our view.
- The macroeconomic backdrop remains uncertain: a recovery depends on successful vaccine rollouts.
- Leverage has increased in recent years, even as credit spreads have tightened – we believe strong credit research is as important as ever.

Valuations remain supportive for lower rated bonds

- Credit migration has stabilised. We believe improvements in the global economy would result in rating upgrades.
- Fallen angels are historically more likely to become rising stars[1], and we believe they present attractive opportunities.
- BB rated bonds, and the hybrid debt of investment grade borrowers, offer a potential sweet spot based on current valuations. Fallen angels also historically benefit when buyers cross over from investment grade to high yield[1].
- We believe high yield defaults will be higher in the US than in Europe, which has been the case historically.

Credit stock selection remains key

- Navigating these markets requires careful assessment to obtain sufficient compensation relative to the potential risks involved.
- Research coverage by the broker market is narrow, and typically focused on sectors or themes.
- In our view, rating agencies have sometimes been slow to acknowledge changes in issuers' creditworthiness.

We therefore believe a research-driven, value-based approach, such as that employed by M&G, can continue to prosper in this environment.

Our current thoughts

In a typical credit cycle, we have come through the 'destructive' phase and are now in the 'balance sheet repair' phase. Management behaviour typically focuses on rebuilding the strength and resilience of balance sheets, with a view to reducing leverage, restructuring and improving cashflows. Ultimately, we believe this could lead to a period of extended stability. The longer this persists, the likelier it is that management eventually begins to return to higher leverage again, through debt-funded and sometimes ill-conceived or unjustified acquisitions, which can lead to the seeds of 'value destruction' being sown once more.

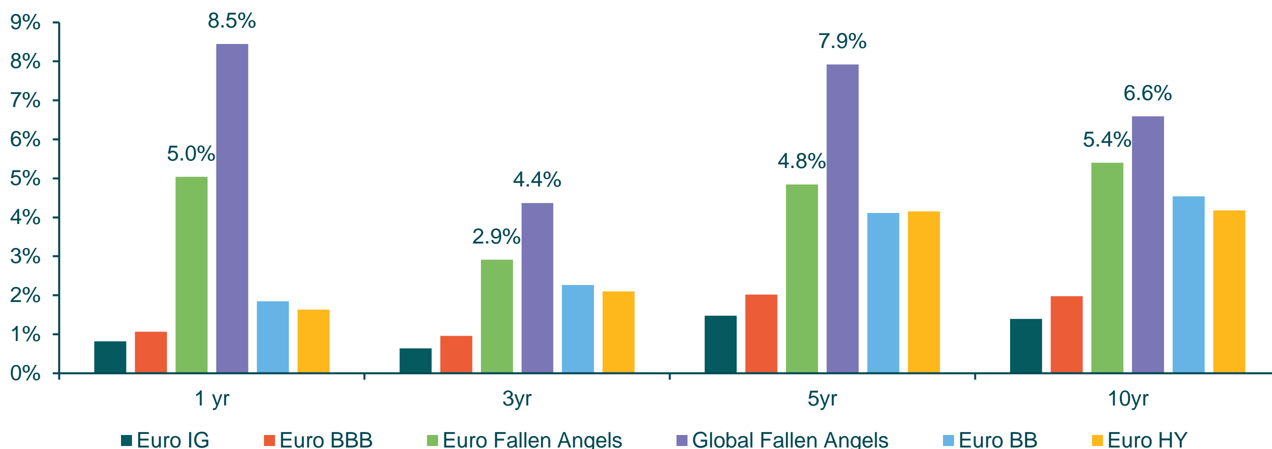
However, the dispersion of available spreads, which are driven by market inefficiencies in pricing the relative risks between borrowers, remains a persistent feature of credit markets. We believe this provides opportunities through the credit cycle. Our bottom-up, research-driven and value-based approach seeks to find those opportunities where risk and market pricing are misaligned.

Looking ahead in 2021, we believe some misunderstood credits have the potential to recover. The market may also refocus on fallen angels (credits that have been downgraded from investment grade to high yield status) and make a more favourable assessment of their longer-term prospects. We believe episodes of market volatility define managers – as such, we have always looked to capture opportunities where we feel the price and risks of issuers have become misaligned. Drawdowns on the scale as 2020 may not be repeated in 2021, but episodes of volatility could again provide attractive entry points for active managers such as M&G.

Currently, fallen angels – both those already downgraded and those that the market anticipates will be – still represent an attractive opportunity, in our view. The long-term historical outperformance of fallen angels can be seen in Figure 1 overleaf.

Additionally, post-crisis, there are many credits that represent interesting opportunities whereby we feel the price of a borrower's debt is not reflective of its underlying credit risks. This includes many names in

Figure 1. Comparative excess returns to swaps (%, annualised)



Past performance is not a guide to future performance.
Source: M&G, ICE BofA indices – Euro Corporate (ER00), BBB Euro Corporate (ER40), Euro Fallen Angel High Yield (HEFA), Global Fallen Angel High Yield (HWFA), BB Euro High Yield (HE10), European Currency Non-Financial High Yield 2% Constrained (HPIC), returns to swaps, 31 Dec 2020.

industries that have been hard-hit by the virus, notably within the automotive, transportation, chemicals and hotels sectors. We believe certain issuers are attractively priced relative to the fundamental strengths of their businesses and their prices continue to reflect the wider markets' uncertainty around their path to recovery. These companies have strong expected future cashflows, large market shares in their industry and high barriers to entry. Identifying these names, and others in troubled areas of the market, requires deep credit analysis – something that is at the heart of our investment research-based approach to investing.

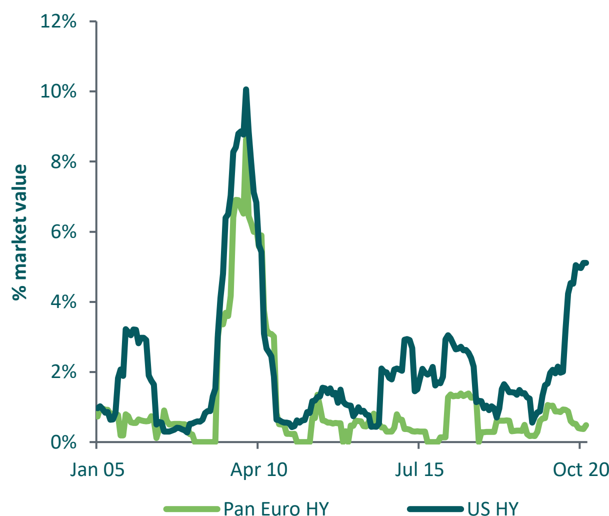
This will be particularly true in European high yield markets, where – with access to funding restored – markets will likely support a return to increased leverage and covenant-lite issuance models. The hunt for yield should once again make access to capital cheap for high yield borrowers. This suggests that near-term market conditions should remain positive, but that investors should be cognisant of the issuer-specific risks. Asset prices in high yield markets have gone straight from the repair to extended phase, but management have yet to deliver and are lagging the current market pricing, which no longer incentivises positive behaviour.

We feel, however, that the hunt for yield has the potential to drive European high yield spreads tighter from current levels. The default experience has historically been significantly lower in European than in the US, as shown in Figure 2. In the US, Chapter 11 bankruptcy is a tried-and-tested way of default and recovery; however, in Europe, political pressures, accommodative banks and difficult-to-navigate bankruptcy restructuring processes, which are highly country-specific, mean there is a greater tolerance for 'zombie' companies that might otherwise have defaulted.

Accordingly, we believe European high yield names will selectively offer interesting company-specific opportunities through 2021.

In our view, the greatest risk in 2021 is complacency in the face of an uncertain economic environment. The danger is that this is supported by central bank largesse and that government stimulus leads to credit spreads remaining overvalued and unreflective of the fundamental credit risks of underlying borrowers. Permanent QE is neither economically nor politically viable, and government stimulus is finite. Any suggestion from central banks or governments of reducing current levels of support could be met with a sharp negative move in spreads. This could provide opportunities to

Figure 2. Par-weighted default rates, Europe vs. US



Past performance is not a guide to future performance.
Source: M&G, ICE BofA indices – Euro Non-Financial High Yield Constrained (HEAD), US High Yield (H0A0), 31 Dec 2020.

potentially add to investment risk, before a possible reversal from the authorities due to the market reaction.

Additionally, periods of overvaluation are typically followed by episodes of volatility, which can provide opportunities as value reasserts itself. While we do not seek to forecast these outcomes, our approach is to de-risk as issuers become overvalued. If we do not see compelling value opportunities, we will not chase marginal opportunities where the risks are insufficiently compensated. Instead, we seek to preserve capital. As a patient, long-term investor, we would hold lower-yielding, high-quality, defensive assets, such as AAA floating rate notes, T-Bills and cash, until we could see better opportunities.

As a value-based, research-driven manager, we believe we can continue to obtain the insights to mitigate issuer-specific risks and capture potential mispricing opportunities during 2021. In a market where the performance dispersion of credits is likely to be wide, even if the overall market continues to rally, we believe a deep understanding of the fundamental credit risks of issuers will be a key driver of investment returns.

Richard Ryan
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M&G
February 2021

Additional reference(s):

1. ICE BofA indices, Global Fallen Angel High Yield (HWFA), Global Original High Yield (HWHY), Global Corporate (G0BC), Global High Yield (HW00), 31 Dec 2020

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